



**Consumer Federation of America**

**TESTIMONY OF**

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**BEFORE THE**

**COMMITTEE ON COMMERCE, SCIENCE AND TRANSPORTATION**  
**OF THE**  
**UNITED STATES SENATE**

**INSURING TERRORISM RISKS AFTER SEPTEMBER 11th**

**OCTOBER 30, 2001**

Good day Mr. Chairman and members of the Committee. I am Bob Hunter, Director of Insurance for the Consumer Federation of America. I previously served as Texas Insurance Commissioner and, of particular relevance to today's subject, as Federal Insurance Administrator under Presidents Ford and Carter.

I served at FIA between 1971 and 1980. My first task was to assist in establishing the Riot Reinsurance Program under the provisions of the Urban Property Protection Act. I strongly encourage you to look at the Riot reinsurance program for guidance in your current important effort for reasons I will cover in the next few minutes.

In the late 1960s, the nation faced great uncertainty from a form of terror from within. There were an awful series of riots in the land. If this were not bad enough for the people in the inner cities who were at the equivalent of what we now call "ground zero," the reinsurers panicked and began to cut off reinsurance protection from the American primary insurance market. The primary insurers, without their layoff arrangements were poised to pull out of the inner cities. Then lenders would have to call mortgages...the set up for a true crisis.

Congress, wisely, stepped in, creating the riot reinsurance program. The program adhered to good insurance principles, requiring the government to charge full actuarial rates for the reinsurance and making sure that claims were appropriate for payment.

I was tasked with the job of coming up with actuarially sound rates for the riot reinsurance program. This was about as fearful a job as I ever faced. There was great uncertainty. But actuarial soundness is not defined as precise prices. It relates to procedures such as using the best information available, making reasoned judgements and basically doing your best. We did that, full well expecting to be too high or too low since future events such as riots are hard to predict.

I met with insurers, actuaries from the actuarial societies and other interested parties and came up with prices. Insurers thought they were OK since they bought the reinsurance. The taxpayer was protected and, indeed, profited from the transaction.

Sound insurance principles require proper prices and require adequate supervision of the claims payment process.

### **CFA SUPPORTS A FEDERAL REINSURANCE PROGRAM FOR TERRORISM**

CFA supports a sound program of reinsurance for the terrorism risk underwritten by the federal government<sup>1</sup>. I attach a list of principles CFA developed for Congress to consider

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<sup>1</sup> This testimony relates to property-casualty insurance. The life insurance industry has requested a Commission to study if they need back-up. CFA believes that a Commission is not needed. The life insurance industry should

when developing the program. Foremost among the principles are that the insurance industry must be able to purchase affordable reinsurance and that the taxpayer be protected.

### **INTERIM TERRORISM INSURANCE PROPOSAL**

CFA understands that creation of the permanent plan we espouse below might take more time than we have to protect insurers as of January 1, 2002, when most reinsurance runs out. We therefore suggest that an interim, actuarially sound plan be developed.

Simply, we believe that most insurers could withstand at least another event of the magnitude of the September 11th tragedy. So we do not think that the interim plan should cover first dollar losses. CFA proposes that a retention be used for each insurer of 5% of surplus, as of December 31, 2001.

“Terrorism” must be defined for this interim plan and should be determined by a federal official.

If a terrorist attack occurs and an insurer suffers claims greater than the retention amount, the insurer would be eligible for federal low or no interest loans, the term of which would be negotiated up to 30 years. This would spread the cost over time, an important goal. For each insurer, the discounted value of the loan would be limited to an additional 5% of surplus.

Amounts of money loaned in excess of the 5% of surplus by company would be repaid to the U.S. Treasury through a property-casualty insurance industry-wide loan repayment mechanism. This loan repayment would be collected over a number of years that are sufficient to minimize the rate impact on consumers (Congress should set the maximum surcharge, perhaps at about 2.5% per year, until the loan is repaid). The surcharge would be collected by the states as a piggyback on their state premium tax mechanism and forwarded on to the U.S. Treasury. This step is needed in order to make sure that individual company balance sheets are not impacted by very large losses due to terrorist activity.

This plan leaves the regulation of insurance fully in state hands. The states should be required to assure availability and affordability of the terrorism risk, using their usual regulatory methods, including pooling by state if necessary. Further, the states should be asked to assure that the plans enhance security through discounts or other incentives. Congress could set goals for the states in this effort. This requires little if any new bureaucracy since much of this sort of work is already part of the state insurance department responsibility.

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make its case for when they might need help and Congress should call hearings to critique that analysis. CFA looks forward to participating in that separate process.

## **NEEDED PROTECTIONS FOR THE TAXPAYER**

Any longer term plan should protect consumers and taxpayers in the following manner:

First, insurance companies should pay full actuarially sound rates for any reinsurance protection they enjoy. Any plan that requires no premium is not actuarially sound. The insurers need a plan to protect their interests – they do not need a hand out. Insurers should be loathe to set a precedent where inadequate premiums are acceptable when they are paying the premium, if they do not expect consumers to press for inadequately priced home, auto, life and other coverages. When the insurers offer free insurance to us, we will consider free reinsurance for them.

Free insurance is particularly galling in year one of the coverage. Don't forget the insurers made contracts with Americans to cover terrorism fully. These contracts are being entered into even as we speak. So, for a year for policies being written today and for an average of about six months for policies already in force, there would be terrorism coverage even if Congress did nothing. To come in after-the-fact and give away insurance to the industry, which is a very healthy industry<sup>2</sup> even after September 11th, would be foolish.

Actuarial soundness is possible. The taxpayer can be assured that, over time, the program would, at worst, cost the taxpayer nothing. Here is how to do it:

- : Congress should require actuarially sound reinsurance premiums. That does not mean precision, it means doing the best you can to set a price you think is based on reason.
- The plan should include assessments against the industry if terrorism reinsurance claims exceed certain dollar thresholds. During the riot reinsurance days, the industry had to agree to a 2.5% of their total premium assessment provision in the reinsurance contract.
- The plan should have a provision stating that if the taxpayer has paid more into the plan than the premiums and investment of premiums, the premium collection aspects of the plan will stay in effect until the taxpayer is made whole. Just as in the riot reinsurance program, the plan can be self-sustaining over time. Uncertainty will end and the costs shifted to taxpayers during the uncertain times can be recouped as certainty returns.

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<sup>2</sup> At year-end 2000, the property/casualty industry had surplus of \$321 billion and net premium written of \$303 billion. The rule of thumb for a very safe industry is a ratio of \$1 of surplus for each \$2 of net premium written. Thus, the industry had "excess" surplus of \$170 Billion. ( $\$321 - \$303/2$ ). So, even if the industry has another WTC event, God forbid, they can afford it.

- The plan should include a wise pay out plan that minimizes taxpayer exposure. The second year of the White House proposal is a good start. That should be the first year of the program. The industry can easily afford a first layer of coverage where they are 100% at risk for tens of billions. I would set it at \$35 Billion<sup>3</sup> for year one. The industry could easily afford three such events even today.
- The federal government should have a claims audit role to assure that only claims that meet the definition of terrorism and are within the contractual provisions of the reinsurance policy are paid.

Second, private insurers should not be able to cherry pick against the taxpayer. By “cherry picking” I mean sending bad risks to the federal reinsurance program and keeping good risks for the industry accounts. Thus, all primary insurance companies should be required to participate in the reinsurance program. At the very least, groups of insurers should not be allowed to reinsure one company with “target” risks (e.g. the Empire State Building) but not reinsure another company in the group (say, insuring farm risks).

#### State Consumer Protections Should NOT be impacted by any Reinsurance Plan

One of the beauties of reinsurance by the federal government is that it is simply a contractual arrangement with the insurer, it does nothing to interfere with the carefully constructed system of state regulation in place.

#### There Must be a Degree of Bureaucracy to Administer the Program

While it can be minimized, you need staff to develop the contract and administer the claims payment process. You cannot just pay claims. If you do, the taxpayer will be ripped off. You need a small but not insignificant staff (maybe 50?) to do this job.

The setting of the premium charge and the collection of the reinsurance premium requires very few staff (maybe 5?).

#### Availability and Affordability of Insurance must be Assured

The reason for Congress to step into this situation with federal back-up is to make sure that the economy is not frozen by lack of insurance for the terrorism risk. To write a plan that

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<sup>3</sup> Some have maintained that this is difficult to do since some who suffered loss early would be more exposed than those with later claims. This is a red herring. What you should do, I think, is to allocate the deductible by insurer based on the sorts of risks they have and their surplus level. Then a smaller insurer might be paid even if a terrorist loss was relatively small but in the locus of the exposure that that insurer wrote.

does not do the necessary to assure that insurance is written and the price is reasonable would be foolish.

This means that the plan should include a requirement of continuation of direct provision of terrorism coverage by insurers as part of the “deal” for taxpayer back-up for those risks that meet minimum security standards. Further it means that the rate charged for primary insurance should be correlated with the reinsurance charges so that there is no gouging by insurance companies at this time of national emergency. Congress should not infringe on the ability of state regulators to assure that price gouging for primary insurance does not occur.

### **CRITIQUE OF INDUSTRY PROPOSAL**

The Consumer Federation of America strongly opposes the industry drafted “Insurance Stabilization and Availability Act of 2001.” This proposal is a massive overreach that unnecessarily exposes taxpayers to billions of dollars in risk. There are several serious problems with the industry approach:

- The bill does not require actuarial soundness. Indeed, insurers would pay nothing for reinsurance for the first year of the program, until the mutual insurance company created under the bill builds up a \$10 billion net asset base. Apparently, this free government reinsurance would even cover policies already in force for which insurers are fully at risk today. This is a grossly improper use of taxpayer monies.
- Insurers can “cherry pick” risks since they could opt in or out of the reinsurance program at will. One insurer of a group of companies could be set up to take all of the “bad” risks and buy the reinsurance, effectively adversely selecting against the taxpayer. Further, cherry picking is allowed in that the insurers can decide whether to reinsure personal risks and commercial risks separately.
- The selection of Illinois as the sole regulator of the new federally backed mutual insurer puts consumers at risk. Illinois, unlike most other states, does not control prices. Congress should not interfere with normal insurance protections afforded business and personal consumers. If Congress decides to interfere, a federal agency should be empowered to regulate the insurers, including the rates charged for the reinsured coverages, to assure that no price gouging occurs. (Why enact a terrorism reinsurance program to make insurance affordable and then let insurers charge whatever they want for the coverage?) If one state were to be used to regulate the rates and policies offered (something CFA does not favor), the most advantageous for consumers would be the largest

state, California. Studies show that California insurance oversight has been the best in the country over the last decade.

- The bill would cover war events only for workers' compensation. The bill should cover war for all lines of insurance and the reinsurance program should be so constructed.
- The bill waives the application of all federal and state anti-trust laws. This is unnecessary and inappropriate.
- The bill allows territorial differences in pricing, which means that New York City will likely pay much higher rates than other cities, particularly if there is no government review of insurer pricing decisions, as the bill proposes.
- There is no guarantee of affordability or availability of coverage to reasonably secure risks.

We urge you to reject the insurance industry proposal and, instead, use the very successful Urban Property Protection Act of 1969 as the precedent for this program, as reflected in the principles developed by CFA (printed below).

### **CRITIQUE OF THE WHITE HOUSE PROPOSAL**

The White House proposal is flawed for several reasons. First, it is actuarially unsound. The taxpayer should not give away reinsurance.

Second, the first year pay-out plan shows a fundamental misunderstanding of insurance. The 80%/20% split starting at the first dollar of terrorism loss will actually leave the taxpayer exposed to 100% of the risk. This is because the plan will reinsure the reinsurers. So, the primary insurers will reinsure the 20% the taxpayer is not on the hook for with the reinsurers. The reinsurers will then "buy" (for no premium) the 80%/20% cover. This will increase the taxpayer share to 96% ( $100\% - [20\% * 20\%]$ ). But that is not the end of the reinsurance process. The reinsurers will again reinsure (called "retrocession") with other reinsurers (possibly including the primary carriers themselves). The taxpayer share will then go to 99.2% ( $100\% - [20\% * 20\% * 20\%]$ ). If they reinsure again (there is no limit on how many times the risk can be ping-ponged to lay off risk on the taxpayer) the taxpayer share would be 99.8%. And so on.

This could be corrected by not exposing the taxpayer to private reinsurance payouts.

A better approach would be to change the plan to have a large deductible. As indicated earlier, I think that amount should be \$35 billion. Over that, there should be sharing as in

year two of the White House plan...but no reinsurance should be allowed on private reinsurance claims even in that scenario.

The White House plan also does not guarantee affordability or availability of coverage to reasonably secure risks.

## **CONCLUSION**

Congress can and should back-up the private insurance market with reinsurance for the peril of terrorism. It can and should do it in a wise way that protects the taxpayer and, over time, assures that the taxpayer is reimbursed for the costs of the program so that the cost goes to ratepayers rather than to taxpayers.

CFA looks forward to working with the Congress on this most important effort.



**Consumer Federation of America**



**Guiding Principles for Insurance Legislation  
Related to War and Terrorism**

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1. CFA supports the concept of federal back-up of the private insurance industry for the perils of war and terrorism. We suggest the riot reinsurance program as a precedent for this backup.
2. Legislation should supplement but not replace other private and public insurance mechanisms where those mechanisms can provide coverage more efficiently. However, all insurers should be required to reinsure against the perils of war and terrorism through the federal government at the outset of the program. In time, as conditions warrant, private reinsurance should be encouraged. To avoid undue taxpayer exposure, however, the program should include a requirement of minimum extended terms for reinsured insurers with claims paid to allow taxpayers to recoup some of the losses.
3. There should be a reasonable coordination and structuring of state and federal regulatory responsibilities with respect to a federal terrorism reinsurance program that achieves the objectives of the program without unnecessarily compromising or preempting state regulatory authority and consumer protections. Necessary preemption of or limits on state regulatory authority should be compensated by requisite federal oversight.
4. There should be an appropriate balance of different private and public interests in the governance of regulatory oversight over the program. Consumers (business and personal), insurers, reinsurers and state regulators of insurance should be on the board of advisors for such program.

5. All records relating to the program, including the records of the reinsured insurance companies should be available for federal audit and, to the maximum extent possible, made public.
6. Rates for the war and terrorism perils charged for the government reinsurance should be actuarially sound and should consider all reasonable factors that can be feasibly measured and supported by theoretical and empirical analysis.
7. The federal government should assure that the cost of terrorism/war coverage charged by reinsured insurance companies to the consumer is actuarially based and correlated in price with the reinsurance offered by the government.
8. The legislation must clearly define “terrorism” and “war” and exclude any coverage beyond those definitions. A top federal official should determine if a specific event falls into either of those definitions.
9. Anti cherry-picking provisions such as the following should be included: Legislation should recognize that many war or terrorism exposures subject the government to potential adverse selection as insurers with less catastrophe risk are less likely to voluntarily purchase coverage, while those with greater risk are more likely to purchase coverage. If legislation were to create a government reinsurance program, the program should encourage the inclusion of both low-risk and high-risk insureds to promote greater risk spreading in a way that does not subject the government to adverse selection.
10. Legislation should promote or encourage coverage that is available to any property that meets reasonable standards of insurability. Federal security requirements should be met within reasonable time periods by insured risks and policed by inspection by reinsured insurers.

11. State residual market mechanisms and other pooling mechanisms for insurance should be allowed to participate in the entity established by legislation to provide war and terrorism insurance, in such a way as to not create incentives for business to be placed in the residual market. To the extent that a risk meets the minimum security requirements, it should be able to get war and terrorism coverage through some source...a residual market if necessary.
12. Jurisdiction over claim settlement practices should remain with the states.
13. Tax law changes should be encouraged to avoid penalties on and encourage the accumulation of reserves for war and terrorism losses.
14. Legislation should encourage loss reduction and hazard mitigation efforts through enhanced security.